I. SERVICES

First let me cover Network Services which continues to grow profitably. For 1975 the revenue of $133 million represents a growth rate of 20% and the profit of 11.0 million, an improvement in rate from 1974 to 1975 of 4.4% to 8.3%. Highlights of the plan include introduction of 7600 CYBERNET Services. Continued growth of KRONOS and CALL 370 time-sharing services in Europe and the U.S. Opening of services in Switzerland and our first full year of services in France. The increased expense rate represents opening these markets as well as Canada and expansion in the U.S.

Local Batch Services as I remarked in November include Mexico, Brazil, and the DPS Division of SBC. Since I covered this subject last time and no significant differences have come up I will not comment further on this business segment. As you are aware our biggest challenge is in Brazil.

Application Data Services continue its record of growth in revenue and profitability. Revenues will increase by 75% over the 1973-75 period while profits will grow to a 12.0% before tax level in 1975. 1974 results include some 500 thousand of extraordinary expenses which ARB has spent on TV meters.
Developmental Data Services do not represent the same business segments from year to year due to start up and close down of some businesses over the year. The $3.6 million loss for 1975 will represent a significant achievement if it is attained. Improvements in 1974 as well as the shut down of Reservations Systems in Atlanta will give us an excellent shot at the budgeted figure, however.

II. AEROSPACE, INSTRUMENTS AND CONTROLS

Next, I will cover our Aerospace and Military Products business and the Instruments and Controls business.

In Aerospace and Military Products we had a good year in 1974. As you can see from the chart the business has grown in revenue and profits. Profit rates are expected to improve in 1975 over 1974.

In Instruments and Controls we are beginning to make some progress. 1974 saw a profit improvement of $700K over 1973. In 1975 we have an excellent chance of seeing this profit climb to over a million dollars. The budgeted profit of $1.9 million, I have to say, is a very stretched plan and will be extremely difficult to achieve.

III. EDP SYSTEMS

This next chart shows 4th quarter and full year 1974 results for EDP Systems. "Current Projection" is our preliminary closing number. "Prior Projections" are the numbers we saw at the November
Board meeting. As you can see we have a loss increase of 21.3 million dollars. Half of this amount is an ALS provision which we will talk about as a separate subject later in the meeting.

At the operating net profit line however there has been a deterioration of $9,128K, and it is this that I want to address at the moment. Almost $3 million of this change is in expenses - some $2,955,000.

As Mr. Norris remarked one item alone was a $4.8 million currency loss. There was also an interest expense increase of $1 million dollars. Another 900 thousand was increased costs in idle equipment depreciation. These additional costs were offset by some $3.7 million dollars in expense reductions in other areas to yield the net difference of $3 million.

The $6,163 deviation above the expense line flows directly from the revenue and gross profit stream. I will come to that.

But I want to remark here that with the exception of the currency exchange loss the negative deviations are in part attributable to lack of forecasting ability and control for systems revenue and gross profit. So in the expense and gross profit categories combined, a problem of over $8 million dollars arose in two months time which could have been foreseen perhaps with a better system. No "system" will ever overcome the basic instability of the systems market place but I'm convinced we can do better.
But back to the $6,163K change in gross profit. The make-up of the change appears on the next chart.

The first item is outright sales revenue and g.p. change due to change in delivery dates - either earlier or later - of orders in backlog. The second item is the outright sales and gross profit effect due to loss of orders, increase due to unexpected orders and so on. The third is change in the installed lease base from previous forecast - this can be due to credits given to customers, slipped deliveries, unexpected cancellations, accelerated installations, unanticipated technical support for a lease customer and so on. The final category are overrun charges to costs of sales on installed equipment. With the exception of 117 thousand dollars, this $2,034K is all from international business. A large portion of item 3 is also international.

But, again, basically items 1 and 2 derive from flaws in our prospect/backlog, order and revenue forecasting process. Items 3 and 4 derive from lack of visibility and control of the lease base and charges against it. Later in the agenda Paul Miller and I are going to address the program we have to correct this. The 1975 budget numbers which I am about to show you were established using this new system and process and our degree of confidence has gone up significantly by its use.
The highlights of this budget are the following:

- A plan for $12 million less in revenue and $15 million less in gross profit.

- On a quarterly basis the first and second quarters are the largest losses. Beginning in the third quarter improvement comes with the advent of CYBER 170 deliveries.

- Expenses will be cut by $18.3 million dollars. On a quarterly basis this reflects a decline from $44.3 million in the first quarter to $39.4 million in the fourth quarter. More specifically from 1974 to 1975 - technical effort will be reduced by $9.0 million Marketing by 500K. Interest by $7.7 million and Administrative and other expense by $5.2 million. The interest expense is reflective of a decrease in average assets from $717.3 million to $686.4 million. This reflects improvement in several categories for our systems. This next chart will illustrate this. The highlights are:

  - Receivables reduced by an average of $2.8 million due primarily to an improved ratio of "collectable" revenue, and planned improvements in collection performance.

  - Inventory reduced by $8.9 million due to improvements in inventory turn performance, introduction of the CYBER 170 representing a lower cost of sales output, and reduced level of output to the lease base.
Leased equipment reduced by $2.9 million. $60 million in gross additions to the base will be offset by depreciation throw-off.

Deferred assets reduced by $22.8 million due to write-off of all deferred R&D.

The initial forecast from the prospect/order/revenue system I referred to earlier shows on the basis of backlog and high probability prospects a gross profit figure of just over $150 million dollars. This figure is more optimistic than the budget numbers I have shown you. To the extent that we can make this hold or improve throughout the year, we will of course improve the numbers you see.
Paul Miller has discussed with you the description of a new system now in place for revenue and gross profit forecasting, but I would like to add a few thoughts to his.

First off, as I pointed out earlier today, Systems revenue planning has been by far one of our most serious deficiencies in previous years and particularly in the year of 1974. Looking back into 1974 we have projected revenues for systems for the full year to be as high as $345 million (including UBS) to what now appears to be a revenue of $294 million for the full year (including UBS). Even if UBS is excluded as an unexpected change, the variation of 51 million is unacceptably large even in a low volume, high unit price business like our systems business.

Further, since our expectations for revenue are reflected in our build schedules, we will have some 20 CYBER 70 computers in inventory and available in spite of our attempts to reduce schedules as we learned through the year of new and lower projections.

Of course the effects of this continuing change and wide range of expectations can only mean higher costs, weakened product programs and more organizational stress.

We have therefore applied substantial effort to get a stronger and more understandable system for forecasting revenue and gross profit.
But the most essential element of this or any such system is that it provide not just a forecast but a real commitment on the part of those people who have the ability to exercise control.

This effort goes back some time now and I would like to tell you a small history of our development of this system. In December of 1973 I established a project to develop a system to better manage our lease base. My thoughts at that time were that what we now call the Lease Base Management System would allow us to manage the larger transactions that add and subtract from our monthly lease revenues, and further, that the total lease base investment could be more readily analyzed.

In March of 1974 I established another major program which was an attempt to better manage our technical effort as we invest it and as it flows to the P & L. Of particular concern to me was the large cost of technical effort dollars in cost of sales which, of course, affects our gross profit.

In April, 1974 the technical effort project and lease base investment project were made part of a single effort to better manage these three basic functions of revenue and gross profit planning, technical effort and cost of sales planning, and lease base management.

The system itself actually builds on three existing systems that existed in the Company. But systems which were uncoordinated with one another and not viewed as a whole. One consequence was poor data integrity. Take for example the basic prospect reporting system.
While the system was used for looking at order prospects, it was not being used for revenue or gross profit planning. Another adhoc system had built up over the years for that purpose. So we have had amongst other things to reemphasize the prospect system in terms of its data integrity. This prospect information comes directly from our field sales people and properly used and controlled can provide order information, revenue information, revenue acceptance dates, sales price discounting information, customer configuration information for cost of sales, and technical effort project descriptions for technical effort cost estimating.

But beyond that comes the really important part: in the review of this data and as we compare its statistics to those of history, judgments must be made which turn a simple statistical display into a commitment and revenue projection. Through this total process from gathering the data to applying judgment we expect to achieve a quantum change to our commitment levels and, certainly in our ability to track and analyze these commitments.

In summary, I have strong confidence in the better ability to manage the business based on the use of this system by our total operating groups. In review of 1974 the statistical numbers of revenue acceptances and lease/purchase mix were not that unusual. This leads me to believe that our projections were not in accordance with this historical base and had we known this we might have reacted differently.
I. Background

ALS as we all now was designed as a total system with a unified data base to remove redundant data storage and with a communication network to allow all points in the network access to the data base. The data base involved is probably the largest ever envisioned in an on-line system. The transaction requirements as sophisticated as on any known system.

The central select method was chosen as the means to procure the system. A benchmark was established which was to represent typical workload mix in order to evaluate all manufacturers on a common baseline. The Air Force application programs were interfaced to the manufacturer's operating system via an Air Force written suboperating system called Central Control System (CCS). A vendor who passed the benchmark in the specified time could adequately do the ALS projected workload. Control Data passed the benchmark, met all other technical requirements and was awarded the contract in April of 1972.

This contract did not include Control Data Corporation having systems integration responsibility.

As the joint effort began the Air Force was responsible for CCS and the application programs and CDC's responsibilities were the operating system, data management subsystem, communications subsystem and computer hardware.
In a strict sense Control Data has met its contractual obligations. On the other hand as we have mentioned before the system is not in a production mode. Control Data has had problems — especially with ECS and the instability expected in a green software system. One of the chief stumbling blocks however has been the CCS software system written by the Air Force. The overhead was such that 92% of the machine was estimated to be consumed in the operating system. Recovery has been awkward and so on.

Over the last six months and stimulated by a new man in the controller's spot at AFLC, the Air Force has been evaluating its position in the light of an obvious delay in reaching the benefits envisioned from ALS and the budget squeeze on Air Force funds.

II. The current situation

AFLC - Data Automation Group is recommending to the Air Force that the ALS program be redirected as follows:
1. That a basically batch data processing approach be taken

2. That they minimize the contracted difficulties involved in abandoning the Zodiac approach by keeping control data equipment as is necessary to run scope. The amount of this equipment is less than for the Zodiac approach.

3. That the only on-line application currently in operation be maintained as the core of a limited on-line set of applications which would interface via tape to the batch system.

4. This current on-line application runs on 360/40's. The proposal is to upgrade the 40's to 65's or 370/155's to provide the necessary hardware capability to handle additional on-line applications.

5. They currently estimate their work load as 75% batch, 25% on-line.

6. To get the contractually available discounts, AF must buy a specified list of equipments. This specification is contained in Contract Modification No. P00025. When we speak of the "Mod 25 equipment" that's what is meant.

7. The Air Force does not need all the Mod 25 equipment for this approach. Specifically they do not need the terminals - or at least most of them. They do not need much of the ECS. (Currently 13 Mil words installed. Mod 25 calls for ____ million. They would normally recommend 6 million).

8. There are 2 Cyber systems installed and on rent beyond the 14 called for in Mod 25. There are 4 others on order.
I will show you two financial analyses. One assumes that the Air Force retains only the MOD 25 equipment. The second assumes they keep beyond that all currently installed equipment. The first analysis corresponds to abandoning ZODIAC and using SCOPE only. The second provides the wherewithal to continue ZODIAC development.

- Go over Case I, Case II Charts -

III. Further consideration

At this point CDC is in a position of "rocking the boat". Alder and his chief civil servant have decided that the best approach considering contracts, objectives and current status is to go CDC for batch on SCOPE and IBM for on-line using their specialized operating system developed at AFLC. They don't want to spend time or effort on ZODIAC any longer. Our pressing this frustrates them. So any presentation we make invites an enormous amount of nit-picking and attacks on our credibility, responsiveness, diligence, and technical capability.

We can lay down and accept their approach. We can press for more — and the wherewithal to continue our on-line transaction approach.

The short term difference is minimal — some 3 million dollars. But the long range implication is the real factor. Over the next ten years the on-line requirements will grow. They will grow around the IBM core or they will grow around the CDC core. But additional equipment needs will grow around the on-line system.